Supreme Court, U.S.
FILED
APR 11 2001
OFFICE OF THE CLERK

No. 00-1422

IN THE

Supreme Court of the United States

THE KROGER CO.,
Petitioner,

v.

THE KANSAS DEPARTMENT OF REVENUE,
Respondent.

On a Petition for a Writ of Certiorari to the Supreme Court of Kansas

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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April 11, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioner.[1] Tax Executives Institute (hereinafter "TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 5,300 members who represent nearly 2,800 of the leading businesses in the United States, Canada, and Europe, nearly all of which are engaged in interstate commerce.

The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the due process and Commerce Clause rights of business taxpayers.

The overarching issue in this case is whether the disallowance of an interest expense deduction attributable to a loan used, in part, to defend against a hostile takeover attempt is at odds with the holding of this Court last term in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). In that case, the Court unanimously invalidated a California statute that impermissibly assumed that all borrowings by a nondomiciliary taxpayer supported its nonunitary investments. The holding of *Hunt-Wesson* is essentially this: *Because the California statute did not reasonably allocate expense deductions to the income that the expenses generated, the statute violated the Due Process and Commerce Clauses of the U.S. Constitution.*

The constitutional rights of many if not most companies represented by TEI members are implicated and, indeed, potentially threatened by the decision of the Kansas Supreme Court in this case, which arbitrarily limits the interest expense deduction of an indisputably unitary business. Even those members whose companies are not doing business in Kansas are, almost without exception, engaged in interstate commerce. Consequently, they benefit from, and are entitled

to, the positive business environment assured by the Commerce and Due Process Clauses. Moreover, unless Kansas's attempt to skirt this Court's holding in *Hunt-Wesson* is thwarted, other States may be emboldened to follow suit, thereby vitiating the protections afforded by the Constitution.

Because TEI members and the businesses by which they are employed will be materially affected by the Court's decision whether to review this case, the Institute has a special interest in the outcome of this case.

SUMMARY OF ARGUMENT

1. Last term, this Court unequivocally and unanimously held that a State cannot do indirectly—by denying a legitimate business expense deduction—what it is forbidden to do directly—taxing income that is earned outside its jurisdiction. *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). Like the California statutory scheme struck down in *Hunt-Wesson*, the State of Kansas's attempt to indirectly tax income that it has no right to reach should fail.

2. To effect a "fair apportionment," the States have developed formulae to determine what part of a taxpayer's income is part of its "unitary" business and therefore may be taxed by the respective States. The purpose of any apportionment formula is to assign to the taxing State the amount of taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State. If a State errs or overreaches in defining a taxpayer's unitary business—for example, by including nonapportionable items of income in or excluding apportionable items of expense from the tax base—its formula will violate constitutional norms. *See Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992).

The constitutional issue in this case is whether the State of Kansas's disallowance of a deduction for interest paid by an

out-of-state company to replace current debt and to thwart a hostile takeover does violence to the unitary business principle and hence contravenes the U.S. Constitution by effectively taxing income beyond the State's constitutional reach. Just last term, this Court unanimously struck down a California statute that sought to deny a taxpayer a deduction for interest on the grounds that all borrowings by the taxpayer supported its nonunitary investments. The Court found such an assumption constitutionally beyond the pale. *Hunt-Wesson*, 528 U.S. at 465. At a minimum, the holding in *Hunt-Wesson* calls into question the propriety of the State's action here. *Amicus* TEI respectfully submits that decision, which the court below did not even mention, undermines completely the State's action.

3. During the years in issue in this case, the State of Kansas used the so-called transactional test for determining business income, the controlling factor for which is the nature of the particular transaction giving rise to the income. To constitute business income, the transaction and activity must be incurred in the regular course of the taxpayer's business operations.

In this case, the Kansas Board of Tax Appeals disallowed as an apportionable business expense the debt service incurred by the Kroger Company, among other things, to fend off a hostile takeover attempt. (App. at 2a).[2] The taxpayer appealed, and the Kansas Supreme Court affirmed, holding that "the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense." (App. at 15a.) It is this characterization that is at issue here.

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[2] "App." references are to the various appendices bound with the Petitioner's Petition for a Writ of Certiorari to the Supreme Court of Kansas in *The Kroger Co. v. The Kansas Department of Revenue*, No. 00-1422 (filed March 12, 2001).

4. More than a century and a half ago, this Court confirmed that "a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *The Passenger Cases* (*Smith v. Turner*), 48 U.S. (7 How.) 283, 458 (1849). In *Allied-Signal*, the Court confirmed the unitary business principle, while validating the "necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. Last year, the Court revisited the unitary business principle in the context of a deduction. In *Hunt-Wesson*, this Court considered whether the Constitution permitted the State of California to carve out an exception to its interest expense deduction, which it measured by the amount of nonunitary dividend and interest income that a nondomiciliary corporation had received. 528 U.S. at 464. Because "that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax," the Court held that the statutory scheme was unconstitutional. *Id.* at 465.

The failure of the State of Kansas to reasonably apportion Kroger's interest expense in this case should likewise fail. The borrowings that gave rise to the interest expense here benefitted Kroger's unitary business and, therefore, were related to, and permitted the continuation of, "the taxpayer's regular trade or business." For the State to assert otherwise suggests either that it misapprehends the distinction between business and nonbusiness income or that it is driven less by adherence to constitutional principles than by a desire to maximize its revenues from nondomiciliary companies.

The cases relied on by the State—which all involved either a cessation of a taxpayer's business or other significant change in its corporate structure—are inapposite. Here, the taxpayer disposed of no stock and effected no changes in its corporate structure. Rather, it engaged in transactions (borrowings) that are an integral part of its regular trade and

business and that, not coincidentally, permitted the taxpayer's unitary business to remain intact. Accordingly, the interest incurred as a result of those borrowings should be properly taken into account in determining the taxpayer's apportionable income.

5. The Commerce and Due Process Clauses operate as a constitutional brake on the State's efforts to tax extraterritorial income. Having been blocked in their attempts to do this directly, some States (such as California in *Hunt-Wesson*) have turned to a denial of legitimate business deductions. Kansas's attempt here to reach Kroger's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The State's disallowance of Kroger's interest expense deduction should not be condoned.

ARGUMENT

I.

This is not a difficult case. Last term, this Court unequivocally and unanimously held that a State cannot do indirectly—by denying a legitimate business expense deduction—what it is forbidden to do directly—taxing income that is earned outside its jurisdiction. *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). Like the California statutory scheme struck down in *Hunt-Wesson*, the State of Kansas's denial of an interest deduction here represents nothing more than a backdoor attempt to tax indirectly income that it has no right to reach. Its attempt should fail and, accordingly, the decision below should be reversed.

II.

This is the latest in a series of cases to come to the Court on the question of what connection, or nexus, must exist between a State and a nondomiciliary taxpayer's income from out-of-state sources or activities before that income can be

apportioned to, and therefore taxed by, the State. In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the Court confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Id.* at 460. To effect such a "fair apportionment," the States have developed formulae to determine what part of a taxpayer's income may be properly taxed by the respective States. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA)—which the State of Kansas has adopted—the formula compares (1) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (2) the taxpayer's total property, payroll, and sales. UDITPA §§ 9-17. The purpose of any apportionment formula is to assign to the taxing State the amount of taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State.

The general permissibility of formulary apportionment, however, should not obscure or minimize the Constitution's limitation on the States' ability to tax out-of-state income. As the Court held in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), "[u]nder both the Due Process and the Commerce Clauses of the U.S. Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its border.'" *Id.* at 164 (*quoting ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)). The Court continued in *Container* that dividing income among the several States resembles "slicing a shadow." *Container Corp.*, 463 U.S. at 192. Absolute consistency among taxing authorities "may just be too much to ask," *id.*, but there are indisputable constitutional limits on a State's use of a given formula to tax income derived from

interstate commerce.[3] In other words, although having discretion, no State has *carte blanche*, either in devising or applying its apportionment scheme. The shadow must be sliced, and it must be sliced fairly. If the State has not "given anything for which it can ask return" in respect of the person, property, or transaction it seeks to tax, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), the Commerce and Due Process Clauses operate to limit the State's raw power to tax. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (the Court has a duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers").

For more than a century, the key to the Court's constitutional analysis has been the application of the unitary business principle, which focuses on whether the out-of-state item that the State is seeking to tax is "unitary" with, or functionally related to, that taxpayer's in-state activities. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), the Court explained that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439 (footnote omitted). Hence, unless the unitary business principle is correctly applied, the apportionment formula employed by the State could render a constitutionally impermissible result. The unitary tax principle calculates the local tax base by "first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary

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[3] In evaluating challenges to state taxing schemes, the task is to examine whether the challenged tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

business' between the taxing jurisdiction and the rest of the world" based on a formula "taking into account objective measures of the corporation's activities within and without the jurisdiction." *Container Corp.*, 463 U.S. at 165.[4] If a State errs or overreaches in defining a taxpayer's unitary business—for example, by including nonapportionable items of income in or excluding apportionable items of expense from the tax base—its formula will violate constitutional norms. *See Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992).[5]

The overarching constitutional issue in this case is whether the State of Kansas's disallowance of a deduction for interest paid by an out-of-state company to replace current debt and to successfully resist a hostile takeover effort does violence to the unitary business principle and hence contravenes the Commerce and Due Process Clauses by effectively taxing income beyond the State's constitutional reach.[6] Just last term, the Court in *Hunt-Wesson* unanimously struck down a California statute that sought to deny a taxpayer a deduction

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[4] Although the terms "allocation" and "apportionment" are often used interchangeably in respect of the division of income among various jurisdictions, "allocation" properly refers to the "attribution of a particular type of income to a designated state, [and] 'apportionment' refers to the division of the tax base by formula." JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES ¶ 9.01 (3rd ed. 1998).

[5] In *Allied-Signal*, the Court explained that "the unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780; *see id.* at 778 ("[T]here must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.").

[6] U.S. CONST. art. I, § 8, cl. 3 (Commerce Clause); U.S. CONST. amend XIV, § 1 (Due Process Clause).

for interest on the grounds that all borrowings by the taxpayer supported its *non*unitary investments. The Court found such an assumption constitutionally beyond the pale. At a minimum, the holding in *Hunt-Wesson* calls into question the propriety of the State's action here. Indeed, *amicus* TEI respectfully submits that decision, which the court below did not even acknowledge, undermines the State's action completely.

III.

Like many states, Kansas imposes a corporate franchise tax for the privilege of doing business in the State, which starts with the corporation's federal taxable income and is modified to reflect the net income derived from or attributable to sources within the State. KAN. STAT. ANN. § 79-32,138 (App. at 99a-100a). To effect the proper apportionment of income to the State, Kansas generally uses the UDITPA apportionment formula. KAN. STAT. ANN. § 79-3279 (App. at 98a); UDITPA §§ 9-17. Under UDITPA and similar statutes, "business income" is apportioned among all the States in which the taxpayer does business, and "nonbusiness income" is allocated to the taxpayer's state of domicile. *See* KAN. STAT. ANN. §§ 79-3274 through 79-3278 (App. at 94a-97a). Accordingly, the definitions of those terms are critically important.[7]

During the years in issue, the State of Kansas used the so-called transactional test for determining business income, the

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[7] During the years at issue, KAN STAT. ANN. § 99-3271(a) mirrored UDITPA § 1(a), which defined "business income" to mean "[i]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (App. at 93a.) KAN STAT. ANN § 99-3271(e), following UDITPA § 1(e), provided that "nonbusiness income" is "all income other than business income." (App. at 94a.)

controlling factor for which is the nature of the particular transaction giving rise to the income. To constitute business income, the transaction and activity must be incurred in the regular course of the taxpayer's business operations. *Western Natural Gas v. McDonald*, 446 P.2d 781 (Kan. 1968).[8] In this case, the Kansas Board of Tax Appeals disallowed as an apportionable business expense the interest expense incurred by the Kroger Company, among other things, to fend off a hostile takeover attempt. (App. at 2a).[9] The Board classified the expense as a nonbusiness expense, which was allocated to Kroger's state of commercial domicile (Ohio). The taxpayer appealed, and the Kansas Supreme Court affirmed, holding that "the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense." (App. at 15a.) It is this characterization of Kroger's legitimate interest expense—which significantly increases its Kansas tax liability—that is at issue here.

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[8] For a general discussion of the differences between the "transactional" and "functional" tests for defining "business income," *see* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *supra*, ¶¶ 9.05[2][a] through 9.05[2][c]. Although the States have discretion to adopt a definition of business (or apportionable) income that is *narrower* than the Constitution permits and although both the transactional and the functional tests can produce constitutionally acceptable results, there is no guarantee that the application of either definition in particular cases will comport with the unitary business principle and the dictates of the Court's state taxation jurisprudence. *See id.* ¶ 9.05[1][b]. In other words, the definitions of business income and constitutionally apportionable income are similar, but not necessarily coextensive.

[9] Although the court below stated that all the debt was incurred in connection with management's decision to resist the takeover attempt (App. at 2a), that was not the case. Only 80 percent of the debt was used for that purpose; the remaining 20 percent was used to retire existing long-term debt. (App. at 77a.)

IV.

The State of Kansas here does not stake a claim to taxing directly the nonbusiness (that is to say, nonapportionable) income of a nondomiciliary taxpayer. Rather, the State seeks to tax the income indirectly by disallowing a deduction for interest expense that the Kroger Company incurred in the regular course of its unitary business. Such a taxing scheme cannot withstand scrutiny, especially in the aftermath of the Court's decision in *Hunt-Wesson*.

More than a century and a half ago, the Court confirmed that "a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *The Passenger Cases* (*Smith v. Turner*), 48 U.S. (7 How.) 283, 458 (1849). This principle that a State may not, through sleight of hand, indirectly tax constitutionally protected income continues to have vitality today. Thus, in *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 404-05 (1984), the Court found that it is irrelevant that a State discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. *Accord National Life Ins. Co. v. United States*, 277 U.S. 514, 520 (1928) ("What remains after subtracting all allowances is the thing really taxed."). More to the point, formal distinctions lacking in economic substance have no constitutional significance. *Westinghouse Electric Corp.*, 466 U.S. at 405. As the Court noted last term in *Hunt-Wesson*, "[a] tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." 528 U.S. at 464 (*quoting Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted)). *Cf. Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-83 (1924) (States' efforts to tax income from non-unitary entities must not be "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation").

In *Allied-Signal*, the Court confirmed the unitary business principle, while validating the "necessary limit on the States'

authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. There, in asking the Court to jettison the unitary business principle, the State argued that multistate corporations regard all their holdings as asset pools and therefore any distinction between operational and investment assets is artificial and should be ignored. 504 U.S. at 784-85. This Court wisely rejected this strained contention, noting instead that the relevant inquiry must focus on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785.

Last year, the Court revisited the unitary business principle in the context of a deduction. In *Hunt-Wesson*, this Court considered whether the Constitution permitted the State of California to carve out an exception to its interest expense deduction, which it measured by the amount of nonunitary dividend and interest income that a nondomiciliary corporation had received. The statute did not directly impose a tax on nonunitary income; rather, it denied the taxpayer the use of a portion of an interest deduction from unitary income. 528 U.S. at 464.

The State in *Hunt-Wesson* sought to justify its taxing scheme on the grounds that it prevented a corporation from borrowing to support its business needs, while freeing the company to use unencumbered funds to purchase nonunitary business assets. Although positing that "[i]f California could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income, the limit would not, in fact, be a tax on nonunitary income," 528 U.S. at 465, the Court struck down the statute as unconstitutional. There was no factual support for California's facile argument, only its hollow assertion: "The California statute . . . pushes this concept past reasonable bounds. In effect, it assumes that a corporation that borrows any money at all has really borrowed that money to purchase or carry its nonunitary

investments." 528 U.S. at 466 (citations and internal quotation marks omitted). Because "that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax," the Court held that the statutory scheme was unconstitutional. *Id.* at 465.

At bottom, *Hunt-Wesson* was a simple case of a State's failing to adopt a reasonable expense allocation method, thereby impermissibly taxing income beyond its jurisdiction. A similar failing by the State of Kansas here should lead to the same result: invalidation of the State's denial of the taxpayer's interest deduction as unconstitutional. Here, the State seeks to justify its denial of Kroger's interest deduction on the grounds that the underlying debt was not incurred in the normal course of business. Hence, the Kansas Supreme Court concluded that "[the Board of Tax Appeals] is correct that under the transactional test [for defining 'business income'], the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense [that is nonapportionable]." (App. at 15a.)

This line of argument, this attempt at misdirection, must fail for several reasons. First, as Board member Robert Frey observed in his dissent from the interest denial decision, hostile takeovers may not occur often, but the defense against them is not unrelated to the taxpayer's business activities: "Financial management of a publicly held corporation is something that must be done in the regular course of taxpayers' trade or business." (App. at 72a-73a). Indeed, he observed, incurring the debt was an "astute business decision that possibly saved the company." (App. at 73a.)[10] To be sure, takeover attempts do not occur every day, but in this

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[10] Moreover, 20 percent of the debt (and, therefore, 20 percent of the interest incurred) was used to retire debt that the taxpayer accumulated through the course of its operations for which the State previously permitted a deduction. (App. at 77a.)

case the taxpayer's successful defense against the attempt allowed the taxpayer to maintain its operations in the State. In other words, the borrowings that gave rise to the interest expense benefitted the unitary business and, therefore, were related to, and permitted the continuation of, "the taxpayer's regular trade or business." For the State to assert otherwise regrettably suggests either that it misapprehends the distinction between apportionable (business) and allocable (nonbusiness) income or that it is driven less by adherence to constitutional principles than by a desire to maximize its revenues from nondomiciliary companies.

Second, although the denial of a portion of Kroger's interest expense might be constitutionally permissible if the State "could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income," *Hunt-Wesson*, 528 U.S. at 465, it makes no such showing here. Indeed, its position is supported not by any facts, but merely a grand assertion. It seeks to convert Kroger's legitimate interest expenses into nonbusiness, nonapportionable items simply by arbitrarily wishing it so. As the Court held last year in *Hunt-Wesson*, this approach does not pass constitutional muster.[11] This conclusion is supported by the parties' stipulation that the taxpayer treated its interest expense on its Kansas returns in exactly the same manner as it treated the expense on the returns it filed with 30 other states. (App. at 77a.) Like the State of California in *Hunt-Wesson*, the State of Kansas stands alone in arbitrarily disallowing a deduction for *all* of Kroger's interest expense. Its action is not reasonable and constitutes "impermissible

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[11] "A state tax code that unrealistically assumes that every . . . borrowing [by a business with taxable and nontaxable income] first helps [generate the nontaxable income] . . . fails to 'actually reflect a reasonable sense of how income is generated.'" *Hunt-Wesson*, 528 U.S. at 466 (*quoting Container Corp.*, 463 U.S. at 169).

taxation of income outside its jurisdictional reach." *Hunt-Wesson*, 528 U.S. at 468.

Third, the cases relied on by the State to support its distention of the nonbusiness income concept are inapposite. Specifically, the state court cites several decisions in which the taxpayer successfully argued that a gain was so extraordinary that it should not be classified as business income and hence subject to apportionment pursuant to UDIPTA. *See Robert Half International, Inc. v. Franchise Tax Board*, 78 Cal. Rptr. 2d 453 (1998); *Phillips Petroleum v. Department of Revenue*, 511 N.W.2d 608 (Iowa 1993); *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn. 1998); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993). (App. at 9a-13a.) The State then asserts that the reciprocal of that argument should also obtain: Where a deduction is "extraordinary," it too should be allocated to the taxpayer's state of domicile and not apportioned among the States.

This argument proves too much. First, it ignores the fundamental difference between items of income and expense. Expense items must be related to income items; they do not stand on their own. Thus, KAN. STAT. ANN. § 79-3274 (App. at 94a-95a) provides that "[a]llocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year." Again, the key term is "related expenses," for expense items must be associated with, or "related to" items of income. To what nonbusiness income does the taxpayer's interest expense relate? It is a question that the State does not deign to answer.

More fundamentally, the cases relied on by the State all involve a cessation of business or other significant changes in the taxpayer's corporate structure. Hence, in *Phillips Petroleum*, the issue was the character of gain resulting from

the sale of gas and oil producing assets; in *Hercules, Inc.*, it was gain from the sale of stock in a corporation; and in *Union Carbide Corp.*, the issue involved gain realized upon the sale and liquidation of seven distinct lines of business, the gains from which were not reinvested in ongoing business operations. The fourth case cited by the court, *Robert Half International*, involved the taxpayer's purchase and cancellation of warrants, which had the effect of materially changing the corporation's structure. *See* Bruce Daigh, Garland Allen & Christopher Witney, *The UDIPTA Business Income Definition and the Cessation-of-Business Concept*, 20 STATE TAX NOTES No. 13, 2001-STT 58-39 (March 26, 2001).

The cessation-of-business cases, however, have no application here, not only because they dealt with gains (not expenses that must be related to specific items of income), but because the transactions giving rise to the gain effected changes in the corporate structure.[12] Here, the taxpayer disposed of no stock and effected no changes in its corporate structure. Rather, the taxpayer engaged in transactions (borrowings) that are an integral part of its regular trade and business and that, because they had the effect of fending off a hostile takeover attempt, permitted the taxpayer's unitary business to remain intact. Accordingly, the interest incurred as a result of those borrowings should be properly taken into

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[12] There are several other cases supporting this analysis. *See e.g. Chief Industries Inc. v. Indiana Dep't of Revenue*, Indiana Tax Court, No. 49T10-9711-TA-193 (Oct. 24, 2000) (capital gain generated on the sale of stock held to be nonbusiness income); *Uniroyal Tire Co. v. Alabama Dep't of Revenue*, Ala. No. 1981928 (Aug. 4, 2000) (gain from the complete liquidation of a corporation's business operations following the sale of a partnership interest held to be nonbusiness income). *See generally* Jordan M. Goodman & Brian L. Browdy, *The Apportionability of Liquidation Gain in Light of Lenox, Inc.*, 11 J. MULTISTATE TAXATION AND INCENTIVES 6 (March/April 2001).

account in determining the taxpayer's apportionable income.[13]

V.

The Commerce Clause and Due Process Clause operate as a constitutional brake on the States' efforts to tax extraterritorial income. *See, e.g., Allied-Signal*, 504 U.S. at 789 (striking down a New Jersey attempt to tax gain realized from a stock sale); *ASARCO Inc.*, 458 U.S. at 328 (striking down Idaho's attempt to include dividends, interest, and capital gains from a subsidiary in the parent corporation's income); *F.W. Woolworth Co. v. Taxation and Revenue Dep't of New Mexico*, 458 U.S. 354, 373 (1982) (striking down New Mexico's taxation of dividends received from the taxpayer's foreign subsidiary). Having been blocked in their efforts to tax such income directly, some States (such as California in *Hunt-Wesson*) turned to a denial of legitimate business deductions. *See, e.g., Hunt-Wesson*, 528 U.S. at 460. *See also* OHIO REV. CODE ANN. § 5733.042 (restricting the deductibility of royalties and interest expense between related entities); CONN. GEN. STAT. § 12-218c (same). The State of Kansas's action in this case thus reflects a disturbing trend among the States to tax extraterritorial income by denying legitimate business deductions. This pattern should be stopped.

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[13] An attention-grabbing feature of this case is the extremely large amount of money that the taxpayer borrowed: $4.1 billion. Although the court below never specifically linked the size of the borrowings to its characterization of the interest expense as "extraordinary," the magnitude of the expenditures cannot be ignored. *See* App. at 71a (Dissent of Board Member Robert G. Frey) ("If there is anything unique about the expense in this case it is the size of the loan negotiated by the company and the resulting debt service expense.") *Amicus* TEI submits, however, that in construing the terms "business income" and "nonbusiness income," the term "extraordinary" is better understood to relate not to the quantum but rather the character of the item involved.

This Court "act[s] as a defense against state taxes which, whether by design or inadvertence, . . . attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions." *Trinova Corp.*, 498 U.S. at 386. As Robert Frey, a member of the Kansas Board of Tax Appeals, explained in his dissent below: "The result of the removal of the interest expense [from Kroger's income] as an 'ordinary business expense' is a substantial penalty, interest and tax, which must be paid by the corporation to the State of Kansas." (App. at 70a). Kansas's attempt to reach Kroger's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The State's disallowance of Kroger's interest expense deduction should not be condoned.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

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April 11, 2001